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COMMENTS

COMMERCIAL BAD FAITH: TORT RECOVERY FOR BREACH OF IMPLIED COVENANT IN ORDINARY COMMERCIAL CONTRACTS

Glenn Edward Tremper

The Montana Supreme Court has extended the availability of recovery in tort for breach of the implied covenant of good faith and fair dealing further than any other jurisdiction. In *Nicholson v. United Pacific Insurance Co.*¹ and in following cases, the court allowed tort recovery for breach of the implied covenant in ordinary commercial contracts.² Other jurisdictions, most notably California, have considered allowing tort damages for breach of the covenant in such contracts, but have hesitated to do so for policy reasons.³ Unfortunately, the Montana court has not justified its ground-breaking decision to extend the tort theory in this manner.

This comment analyzes the Montana Supreme Court's decision to allow tort damages for breach of the implied covenant in ordinary commercial contracts. It calls for a clear discussion of the policy served by extending the implied covenant to ordinary commercial contracts, and reviews the available public policy arguments both for and against such an extension. It concludes that the imposition of tort remedies for breach of the implied covenant in commercial contracts does not serve public policy and recommends that the court and the legislature employ alternative means of deterring bad faith conduct and ensuring full compensation to a nonbreaching party in a commercial contract.

1. ____ Mont. ____, 710 P.2d 1342 (1985).

2. As used in this comment, "ordinary commercial contract" refers to a contract involving mercantile objectives, which is freely negotiated and is between parties of relatively equal bargaining positions. Although the term "commercial bad faith" sometimes refers to the application of the implied covenant in a bank-client relationship, this comment uses the term to describe the application of the tort theory for breach of implied covenant to ordinary commercial contracts.

3. For a list of jurisdictions which have refused to adopt a commercial bad faith doctrine, see S. ASHLEY, *BAD FAITH ACTIONS*, § 11.03 & n.1 (1986).

I. BACKGROUND: MONTANA'S UNIQUE THEORY OF THE IMPLIED COVENANT

Outside observers have been understandably mystified by the peculiar development of Montana's tort for breach of the implied covenant of good faith and fair dealing.⁴ Nearly all jurisdictions,⁵ commentators⁶ and the Restatement of Contracts⁷ conclude that all contracts contain an implied covenant of good faith and fair dealing. Montana refuses to so hold.⁸ Nearly all jurisdictions are reluctant to allow recovery in tort for breach of the implied covenant,⁹ yet when the Montana court has found an implied covenant in a contract, it has always allowed tort recovery.

The cause of this double anomaly appears to lie in the speedy and perhaps hasty growth of the theory of an implied covenant in Montana. In other jurisdictions, the theory of an implied covenant of good faith and fair dealing evolved in identifiable stages. Most jurisdictions initially employed the implied covenant as a principle in contract law. As early as 1933, some jurisdictions were recognizing that every contract contains an implied covenant that "neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract"¹⁰ The courts treated breach of this implied obligation as a breach of contract, and awarded contract damages. Most present authority still considers the covenant to be a contractual term and recommends contract damages for its breach.¹¹

The practice of awarding tort damages for breach of the implied covenant developed later. It was not until 1967 that a California court determined that a breach of the implied covenant in an insurance context could support a remedy in tort.¹² Approxi-

4. See *id.* at § 11.10.

5. See Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 & n.1 (1980).

6. 3 A. CORBIN, *CONTRACTS* § 541, at 97 (1960); 5 S. WILLISTON, *A TREATISE ON THE LAW OF CONTRACTS* § 670, at 159 (3d ed. 1961); Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 232-52 (1968).

7. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

8. *Nicholson*, ____ Mont. at ____, 710 P.2d at 1347.

9. *Speidel, The Borderland of Contract*, 10 N. KY. L. REV. 163, 191 (1983).

10. *Kirke La Shell Co. v. Paul Armstrong Co.*, 263 N.Y. 79, 87, 188 N.E. 163, 167 (1933). See Burton, *supra* note 5, at 404 (listing common law authority recognizing the implied covenant in all contracts).

11. See RESTATEMENT (SECOND) OF CONTRACTS § 232(2) & comment b (1981) (breach of the implied covenant is treated as a breach of contract).

12. *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967). The court in *Crisci* cited *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958), as the first case in which the court allowed tort recovery for breach of the implied

mately eighteen jurisdictions have followed California's example and have allowed tort damages for breach of the implied covenant in insurance contracts.¹³ The next stage, the expansion of tort recovery to non-insurance contracts, has been slow in its development.¹⁴ Although California's courts of Appeal had earlier extended the scope of tort recovery to employment contracts,¹⁵ it was not until 1984 that the California Supreme Court intimated that tort remedies may be appropriate in non-insurance contracts.¹⁶

The historical development of the implied covenant elsewhere stands in sharp contrast to its explosive growth in Montana. The court has never recognized the implied covenant as a contractual term, and has never awarded contract damages for its breach. Instead, the breach of the implied covenant in Montana has been exclusively a theory for tort recovery with little relation to contract law. There is as indicated some basis to question whether the court even requires a contractual relationship. In recent decisions, plaintiffs have claimed a breach of the implied covenant when there was a dispute as to whether an underlying contract even existed between the parties.¹⁷ In each decision the court reviewed the conduct of the defendant to see if it supported a claim for breach of the implied covenant even though the court either rejected or ex-

covenant. For an in depth analysis of the historical development of tort remedies for breach of the implied covenant, see ASHLEY, *supra* note 3, ch. 2.

13. ASHLEY, *supra* note 3, § 8.06 (listing 18 jurisdictions which award punitive damages for breach of the implied covenant); See also Kornblum, *Recent Cases Interpreting the Implied Covenant of Good Faith and Fair Dealing*, 30 DEF. L.J. 411, 431 n.50 (1981) (listing 17 jurisdictions that have allowed tort damages for breach of the implied covenant in the insurance context).

14. Speidel, *supra* note 9, at 191.

15. See Wallis v. Superior Ct., 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984) (extending tort recovery for a breach of the implied covenant in an employment contract); Cleary v. American Airlines, Inc., 111 Cal. App. 3d 443, 168 Cal. Rptr. 722 (1980) (employment).

16. Seaman's Direct Buying Serv., Inc. v. Standard Oil, 36 Cal. 3d 752, 768-69, 686 P.2d 1158, 1166, 206 Cal. Rptr. 354, 362 (1984). The California Supreme Court had suggested earlier that tort remedies may be appropriate in employment situations. Tameny v. Atlantic Richfield Co., 27 Cal. App. 3d 167, 179 n.12, 610 P.2d 1330, 1337 n.12, 164 Cal. Rptr. 839, 846 n.12 (1980).

By 1984, the Montana Supreme Court had already extended tort recovery for breach of the implied covenant beyond insurance contracts to employment and banking relationships, and the relationship between a health service corporation and its members. See *infra* notes 19-24 and accompanying text.

17. Weigand v. Montana Land & Real Estate, ___ Mont. ___, ___, 724 P.2d 194, 195-96 (1986) (holding that an earnest money receipt and agreement to sell and purchase was not a contract); Rowland v. Klies, ___ Mont. ___, ___, 726 P.2d 310, 319 (1986) (describing the underlying agreement as a "very loose, vague and ambiguous oral agreement").

pressed doubts as to the plaintiffs' claims that a contract existed.¹⁸ By giving serious consideration to the possibility of a breach of the implied covenant even though there was no contract between the parties, the court has reached the logical endpoint of its position that the implied covenant creates a strictly extra-contractual duty.

Before the court decided *Nicholson* in 1985, the court had ostensibly bridled the expansion of the tort by limiting the kinds of contracts which contain the implied covenant.¹⁹ The court, however, quickly expanded the list of contractual types which are subject to the implied covenant beyond insurance contracts²⁰ to encompass employment contracts,²¹ contracts between a health service organization and its client,²² contracts between banks and their depositors,²³ and contracts between attorneys and their clients.²⁴ Because of the court's policy of limiting the application of the tort to selected contracts, the major concern of Montana attorneys is what type of contract the court will next subject to the implied covenant. The court's decision in *Nicholson* therefore is of immense importance; in *Nicholson*, the court extended the implied covenant to ordinary commercial contracts and in so doing, sanctioned the use of tort liability for bad faith conduct in today's complex business environment.²⁵

18. *Weigand*, ____ Mont. at ____, 724 P.2d at 196 ("There is no evidence that Montana Land engaged in conduct which could give rise to the [cause of] action [for breach of the implied covenant]"); *Rowland*, ____ Mont. at ____, 726 P.2d at 317 ("This examination [of the plaintiff's evidence] persuades us that as a matter of law, respondent's conduct was not the arbitrary, capricious, unreasonable or impermissible activity which, under *Nicholson*, would justify a claim for breach of the implied covenant.").

19. The view that the implied covenant does not require the presence of a contract, as suggested by the *Rowland* and *Weigand* decisions only arose after the *Nicholson* decision. Prior to *Nicholson*, the court did concern itself with the characteristics of a contract before it imposed an implied covenant.

20. *First Sec. Bank of Bozeman v. Goddard*, 181 Mont. 407, 415, 593 P.2d 1040, 1047 (1979).

21. *Gates v. Life of Montana*, ____ Mont. ____, ____, 668 P.2d 213, 214 (1983) [hereinafter *Gates II*].

22. *Weber v. Blue Cross of Mont.*, 196 Mont. 454, 643 P.2d 198 (1982).

23. *First Nat'l Bank in Libby v. Twombly*, ____ Mont. ____, 689 P.2d 1226 (1984); *Tribby v. Northwestern Bank of Great Falls*, ____ Mont. ____, 704 P.2d 409 (1985).

24. *Morse v. Espeland*, ____ Mont. ____, 696 P.2d 428 (1985).

25. The *Nicholson* holding raised many weighty questions not directly relevant to this comment's discussion. For example, by abandoning the use of adhesion and inequality of bargaining position as prerequisites to tort recovery, the court threw off all prior limits on the application of the implied covenant. The expansion of the tort in Montana threatens to proceed on an unprincipled and therefore unpredictable basis.

Many have pondered whether the *Nicholson* holding imposed the covenant upon every type of contract. This does not appear to be the case, as the court has reaffirmed its statement in *Nicholson* that the implied covenant does not apply to all contracts. *Nicholson*,

____ Mont. at ____, 710 P.2d at 1346-47; *Theil v. Johnson*, ____ Mont. ____, 711 P.2d 829

II. COMMERCIAL BAD FAITH IN CALIFORNIA

In order to understand the full importance of the court's decision to allow tort damages for breach of the implied covenant in ordinary commercial contracts, it is helpful to consider the reluctance of other jurisdictions to do so.²⁶ Most notably, the courts of California have refused to allow tort damages for breach of the implied covenant in ordinary commercial contracts. In *Seaman's Direct Buying Service v. Standard Oil of California*,²⁷ the California Supreme Court refused to sail the "uncharted and potentially dangerous waters" of imposing tort damages for breach of the implied covenant in an ordinary commercial contract.²⁸ Standard Oil of California (Standard) appealed from an award of compensatory and punitive damages which a jury had awarded the plaintiff (Seaman's) after finding that Standard had breached the implied covenant in their commercial contract. Standard contended that the trial court improperly awarded punitive damages, since the California Supreme Court had not allowed tort damages for breach of the implied covenant beyond insurance contracts.²⁹ Seaman's proposed that the court should allow tort remedies for breach of the covenant in every kind of contract.³⁰

The court reiterated California's well-settled rule that every contract contains an implied covenant of good faith and fair dealing. Under such a rule, California courts have awarded contract damages for breach of the covenant in virtually every kind of contract. In allowing tort damages, however, the California courts are more restrained. The *Seaman's* court concluded that only those contracts in which the parties are in a recognized "special relationship" support imposition of tort remedies for breach of the covenant. The court noted:

While the proposition that the law implies a covenant of good faith and fair dealing in all contracts is well established, the pro-

(1985); *Rowland v. Klie*, ____ Mont. ____, ____, 726 P.2d 310, 317 (1986). In *Theil*, Justice Sheehy repeated the court's refusal to extend the implied covenant to all contracts, yet noted parenthetically that he disagrees with this position and would imply the covenant in all contracts. Although the court has strictly refrained from extending the implied covenant to all contracts, it has not been too careful in its language. In *Dunfee v. Baskin Robbins, Inc.*, ____ Mont. ____, ____, 720 P.2d 1148, 1152 (1985), the court approved a jury instruction which stated that "in every contract, such as the contract with Baskin-Robbins, Inc. in this case, there is an implied covenant"

26. See *ASHLEY*, *supra* note 3, § 11.03 & n.1.

27. 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984).

28. *Id.* at 769, 686 P.2d at 1166-67, 206 Cal. Rptr. at 362-63.

29. *Id.* at 768, 686 P.2d at 1166, 206 Cal. Rptr. at 362.

30. *Id.*

position advanced by *Seaman's*—that breach of the covenant always gives rise to an action in tort—is not so clear. In holding that a tort action is available for breach of the covenant in an insurance contract, we have emphasized the “special relationship” between insurer and insured, characterized by elements of public interest, adhesion, and fiduciary responsibility.³¹

The court hesitated to extend tort remedies for breach of the covenant in ordinary commercial contracts, citing weighty public policy concerns. The court stated:

When we move from such special relationships to consideration of the tort remedy in the context of the ordinary commercial contract, we move into largely uncharted and potentially dangerous waters. Here, parties of roughly equal bargaining power are free to shape the contours of their agreement and to include provisions for attorney fees and liquidated damages in the event of breach. They may not be permitted to disclaim the covenant of good faith but they are free, within reasonable limits at least, to agree upon the standards by which application of the covenant is to be measured. In such contracts, it may be difficult to distinguish between breach of the covenant and breach of contract, and there is the risk that interjecting tort remedies will intrude upon the expectations of the parties. This is not to say that tort remedies have no place in such a commercial context, but that it is wise to proceed with caution in determining their scope and application.³²

The court chose not to decide whether tort remedies are available for the breach of the implied covenant in ordinary commercial contracts.³³ Rather, it created a new tort which allows tort damages when, as in the facts of that case, a party fails to perform a contract and then, in bad faith, denies the contract ever existed.³⁴

Many commentators have criticized the *Seaman's* decision's limited injection of tort liability into ordinary commercial contracts.³⁵ Critics generally argue that the “new tort” of bad faith denial of the existence of a contract is so expandable as to be

31. *Id.*

32. *Id.* at 769, 686 P.2d at 1166-67, 206 Cal. Rptr. at 362-63.

33. *Id.* at 769, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

34. *Id.*

35. See e.g., ASHLEY, *supra* note 3, § 11.08; Comment, *Sailing the Uncharted Seas of Bad Faith: Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 69 MINN. L. REV. 1161, 1164 (1985) [hereinafter Comment, *Sailing the Uncharted Seas*]; Comment, *Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing into the Commercial Realm*, 86 COLUM. L. REV. 371, 400 (1986) [hereinafter Comment, *Tort Remedies*].

merely a variation of tortious breach of the implied covenant.³⁶ Nevertheless, the application of the limited *Seaman's* tort since its creation has been rare.³⁷ Instead, decisions by the California Appellate Courts after the *Seaman's* decision have refrained from imposing tort remedies except in cases when the contract contains a "special relationship."³⁸ The status of commercial bad faith in Cal-

36. Even in its broadest interpretation, the *Seaman's* decision did not extend tort remedies for breach of the implied covenant in ordinary commercial contracts in the manner that the Montana court has. See *infra* notes 39-83 and accompanying text. The California Supreme Court may have opened the door for tort damages in ordinary commercial contracts, but the Montana Supreme Court has plainly walked through it.

37. No California court has affirmed a claim for bad faith denial of the existence of a contract based on the *Seaman's* holding. The court in *Gomez v. Volkswagen of America, Inc.*, ___ Cal. [App.] 3d ___, ___, 215 Cal. Rptr. 502, 512 (1985) found the plaintiff's argument for application of the *Seaman's* tort persuasive, but held that tort liability was precluded in that case by state statute. In two cases heard under diversity jurisdiction, federal courts have applied the *Seaman's* tort in California law. *Landsbury v. Scrabble Crossword Game Players, Inc.*, 802 F.2d 1193, 1199 (9th Cir. 1986); *E.F. Hutton & Co. Inc. v. Arneberg*, 775 F.2d 1061, 1065 (9th Cir. 1985) (awarding punitive damages for breach of the implied covenant, citing the *Seaman's* holding).

38. In *Quigley v. Pet, Inc.*, 162 Cal. App. 3d 877, 208 Cal. Rptr. 394 (1984), the court denied tort damages for breach of the implied covenant in an ordinary commercial contract based on the *Seaman's* holding. The court interpreted the *Seaman's* decision as allowing tort remedies for breach of the covenant only in contracts where the parties are in a "special relationship." The court weighed the policy concerns for and against extending tort remedies into ordinary commercial contracts and found reason for caution.

As a practical matter, exposing ordinary parties in commercial contracts to potentially substantial tort damages may serve both useful and harmful purposes. The risk of a contract-tort action may have negative consequences of varied kinds, such as hesitancy to contract in the first place, or later, fear of defending energetically against uncertainties or mistakes. On the other hand, threat of retribution may discourage unethical business practices. General and punitive damages may be appropriate judicial sanctions for those who in bad faith deny the contract itself, but may be much less well chosen for those whose fault lies only in having inadequate grounds to challenge contract terms. An unrestricted rule of tort liability for unfair dealing could convert routine contract cases into contract-tort jury trials, issues of fact regarding perceived tortious conduct being so easily raised.

* * *

Because of the numerous uncertainties involved in contract litigation, the strong public policy of permitting free access to the courts may require an allowance of more freedom of action among contracting parties than in noncontractual relationships.

Id. at 891-92; 208 Cal. Rptr. at 402-03.

In *Wallis v. Superior Ct.*, 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984), the court created a test for determining whether a contractual relationship was a "special relationship" permitting tort remedies for breach of the implied covenant. To arrive at the essential elements of a "special relationship," the court considered the characteristics of the insurance relationship that had made it "special." The court then concluded that contracts must contain certain unique characteristics before California law will allow for tort recovery upon breach of the implied covenant:

[W]e find that the following "similar characteristics" must be present in a contract: (1) the contract must be such that the parties are in inherently unequal bargaining positions; (2) the motivation for entering the contract must be a non-

ifornia is therefore fairly settled. The implied covenant does exist in an ordinary commercial contract. Upon breach of the implied covenant, however, the aggrieved party is only entitled to contract damages.

III. COMMERCIAL BAD FAITH IN MONTANA

The Montana Supreme Court's application of the implied covenant in the commercial context differs sharply from that of the California courts. In recent decisions the court has abandoned the use of adhesion and inequality of bargaining positions as a prerequisite to tort recovery and extended tort recovery to ordinary commercial contracts. This section will review and analyze the decisions which led the Montana court to this position.

A. *Nicholson v. United Pacific Insurance Co.*³⁹

Nicholson was the owner of a large building in Helena.⁴⁰ He contacted United Pacific Insurance (UPI) after learning that it was expanding its Helena office and was seeking new office space.⁴¹ The parties agreed to a draft lease of the premises, with two key provisions of the lease being that Nicholson would confer with UPI about the renovation of the building and that the final plans were subject to mutual approval.⁴²

At the time surrounding the development of renovation plans, a "secret" UPI task force had decided to transfer much of its Helena operation to Salt Lake City, making the new lease unnecessary.⁴³ Instead of renouncing the lease, UPI threw obstacles in the

profit motivation, i.e., to secure peace of mind, security, future protection; (3) ordinary contract damages are not adequate because (a) they do not require the party in the superior position to account for its actions, and (b) they do not make the inferior party "whole"; (4) one party is especially vulnerable because of the type of harm it may suffer and of necessity places trust in the other party to perform; and (5) the other party is aware of this vulnerability.

Id. at 1118, 207 Cal. Rptr. at 129.

California courts have continued to resist allowing tort damages outside contracts of "special relationship" by relying on the *Wallis* criteria. *Gianelli Distrib. Co. v. Beck & Co.*, 172 Cal. App. 3d 1020, 1035, 219 Cal. Rptr. 203, 209 (1985) (where there exists no evidence of a special relationship between a beer maker and its distributors, the contract may be terminated without cause); *Wayte v. Rollins Int'l Inc.*, 169 Cal. App. 3d 1, 20, 215 Cal. Rptr. 59, 71 (1985) (the relationships between an employer, its employee benefit plan and an employee are "special relationships" and thus the employee may receive punitive damages for breach of the implied covenant).

39. ____ Mont. ____, 710 P.2d 1342 (1985).

40. *Nicholson*, ____ Mont. at ____, 710 P.2d at 1343.

41. *Id.*

42. *Id.*

43. *Id.* at ____, 710 P.2d at 1344.

way of Nicholson's performance of the contract, hoping to force him to rescind.⁴⁴ Nicholson found that he and UPI began to disagree over the interpretation of remodeling plans and additional aspects of the project.⁴⁵ The parties had impliedly agreed to construction plans, but, after work began, UPI claimed that it had never approved the plans.⁴⁶ With the deadline for the remodeling project approaching, Nicholson found it impossible to contact the appropriate authorities at UPI's head office to gain approval of his remodeling plans.⁴⁷ UPI rescinded the lease, citing Nicholson's failure to submit complete architectural plans.⁴⁸

Nicholson sued for tort damages for the breach of the implied covenant. The jury returned a verdict in favor of Nicholson, awarding him \$211,000 compensatory and \$225,000 punitive damages. UPI appealed the verdict arguing, among other things, that the award of punitive damages had no basis in law.⁴⁹

The court addressed the issue by first deciding whether the implied covenant of good faith and fair dealing existed in the lease. UPI claimed on appeal that the lease was an arm's length contract and that the court had never extended the implied covenant to contracts where the parties were in substantially similar bargaining positions.⁵⁰ At the trial, however, UPI had sought an instruction that an implied covenant existed in the lease to support its counterclaim of bad faith against Nicholson.⁵¹ Although UPI had thus conceded that the lease contained an implied covenant, the court chose to consider the application of the implied covenant to reach the issue of whether the trial court had properly awarded punitive damages.⁵²

The court began by admitting that it had once held that the "'special considerations' giving rise to the implied covenant in consumer insurance contracts 'do not apply to an ordinary contract between businessmen.'"⁵³ Noting, however, that "[m]uch has happened to Montana case law on this issue" since that time,⁵⁴ the

44. *Id.*

45. *Id.* at ____, 710 P.2d at 1344.

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at ____, 710 P.2d at 1345.

50. *Id.* at ____, 710 P.2d at ____.

51. *Id.* at ____, 710 P.2d at 1346. In fact, the district court gave one of UPI's instructions. *Id.*

52. *Id.*

53. *Id.* (citing *First Sec. Bank of Bozeman v. Goddard*, 181 Mont. 407, 593 P.2d 1040 (1979)).

54. *Id.* at ____, 710 P.2d at 1346.

court silently reversed its earlier decision and allowed tort recovery for breach of the implied covenant in the ordinary commercial contract before it.⁵⁵

Even though the court silently rejected using standards of adhesion or inequality of bargaining position to define the application of the implied covenant, the court's analysis highlighted those standards. In attempting to document its policy of not extending the implied covenant "to all contract breaches,"⁵⁶ the court pointed to its history of implying the covenant into contracts characterized by aspects of adhesion or inequality of bargaining position.⁵⁷

The court did not discuss the policy reasons for allowing tort recovery in ordinary commercial contracts despite an absence of adhesion or inequality. One can only infer from the court's holding that it incorrectly interpreted the California Supreme Court's holding in *Seaman's Direct Buying Service, Inc. v. Standard Oil of California*.⁵⁸ Although the court gave the facts of *Seaman's* a detailed review,⁵⁹ it did not discount the *Seaman's* court's clearly enunciated reluctance to allow tort damages for breach of the im-

55. Only in later cases did the court expressly indicate that it had held in *Nicholson* that an ordinary commercial contract in Montana contains an implied covenant of good faith and fair dealing which may support a recovery in tort for its breach. *Dunfee v. Baskin-Robbins, Inc.*, ___ Mont. ___, ___, 720 P.2d 1148, 1153 (1986).

56. *Id.* at ___, 710 P.2d at 1347. It is unclear why the court chose to use the term "all contract breaches" instead of simply "all contracts." The court's analysis indicates that its concern is with the character of the underlying contract, not the character of the breach.

57. *Id.* at ___, 710 P.2d at 1347. The court noted that it had found adhesion and inequity present when statutes, such as the Unfair Trade Practices Act of the Insurance Code, set forth specific duties on the part of a party in order to redress the inherent inequalities of the contractual relationship. *Id.* The court had also implied the covenant in contracts where there was no statutory duty, but similar indicia of adhesion or inequality were present. *Id.* The court seemed to emphasize that it was because of the presence of elements of adhesion or inequality that it extended the covenant to the contract between a health service corporation and its members, *id.* (citing *Weber v. Blue Cross of Mont.*, 196 Mont. 454, 464, 643 P.2d 198, 203 (1982)), to employment contracts, *id.* (citing *Gates v. Life of Mont.*, ___ Mont. ___, 668 P.2d 213 (1983) (*Gates II*) (extending tort damages for breach of the implied covenant)); *Dare v. Montana Petroleum Mktg. Co.*, ___ Mont. ___, 687 P.2d 1015 (1984). To the contract between an attorney and his client, *id.* (citing *Morse v. Espeland*, ___ Mont. ___, 696 P.2d 428, (1985)); and the relationship between banks and their customers. *Id.* (citing *First Nat'l Bank of Libby v. Twombly*, ___ Mont. ___, 689 P.2d 1226, (1984), and *Tribby v. Northwestern Bank of Great Falls*, ___ Mont. ___, 704 P.2d 409 (1985)).

58. 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984). In the court's silent reasoning, it may also have first adopted the new limited tort developed by the *Seaman's* court for bad faith denial of a contract's existence, and secondly found that UPI had denied, in bad faith, the existence of the implied agreement with *Nicholson* as to the remodeling plans. The court's continued discussion of the implied covenant, as opposed to the tort of bad faith denial of contract suggests that it did not adopt the new *Seaman's* tort. *Id.*

59. *Nicholson*, ___ Mont. at ___, 710 P.2d at 1347-48.

plied covenant in contracts not characterized by a "special relationship." Instead, the court silently adopted tort damages in ordinary commercial contracts and proceeded to an unrelated analysis of what conduct constitutes breach of the implied covenant.⁶⁰

B. *From Nicholson to Dunfee v. Baskin-Robbins*

In *Nicholson*, the parties were of relatively equal bargaining positions and they freely negotiated the lease. The court's approval of the award of punitive damages indicated it viewed ordinary commercial contracts as being subject to the implied covenant, even in the absence of adhesion or inequality of bargaining positions. Unfortunately, the court did not expressly state this in its holding. In fact, the court's emphasis on adhesion and inequality of bargaining positions in its analysis led some to conclude that the court still requires these elements,⁶¹ and presumably would not imply the covenant in commercial contracts free from adhesion or inequality of bargaining positions. Others suspected that the court's holding could be limited to the facts of *Nicholson*, where the defendant had submitted an instruction on the implied covenant in the ordinary commercial contract. Later cases would have to clarify whether the court actually had implied the covenant in ordinary commercial contracts.

Since *Nicholson*, parties to ordinary commercial contracts have raised lack of adhesion and inequality in other cases. In *Theil v. Johnson*⁶² the appellants sought repossession of a motel they

60. After discussing the facts of *Seaman's*, the court continued:

The *Seaman's* Court carefully limited the scope of the new tort to egregious situations. The California Court of Appeals, in *Quigley v. Pet, Inc.* (1984) 162 Cal.App.3d 223, 208 Cal.Rptr. 394, explained this new tort as "depending upon a special kind of impermissible activity."

While we decline to extend the breach of the implied covenant to all contract breaches as a matter of law, as California has done, we agree with the statement in *Quigley*, *supra*, that the tort resulting from its breach depends on some impermissible activity.

Id. at —, 710 P.2d at 1348. The "special kind of 'impermissible activity'" described by the Court of Appeals in *Quigley*, was narrowly defined as "the unfounded protest of any contract term." 162 Cal. App. 3d 877, 891, 208 Cal. Rptr. 394, 402 (1984). The court used the phrase when describing the *Seaman's* holding in which the California Supreme court had formulated a narrow new tort in order to avoid extending tort recovery for breach of the implied covenant to ordinary commercial contracts. The Montana court, however, used the term to describe the general nature of "bad faith" conduct.

61. One national expert on the implied covenant has obviously been confused as to the court's conclusion: "The [*Nicholson*] court concluded that the cause of action for bad faith is available in contract actions generally when 'indicia of adhesion or inequality' are present." S. ASHLEY, *supra* note 3, § 11.10.

62. — Mont. —, 711 P.2d 829 (1985).

had sold to the appellees in an arm's length, freely negotiated agreement.⁶³ The appellees counterclaimed for breach of the implied covenant, claiming that the appellants had acted fraudulently or in bad faith through their activities in securing repossession.⁶⁴ The court instructed the jury on the award of tort damages.⁶⁵ The jury awarded the appellees \$67,000 compensatory damages, yet did not award punitive damages.⁶⁶

The appellants argued that the trial court erroneously submitted the counterclaim to the jury because the parties were of equal bargaining positions and had freely negotiated the agreement.⁶⁷ On appeal, the court affirmed the trial court's decision.⁶⁸ The court did not expressly rule on the objections raised by the appellants. Rather, it found that any error in instructing the jury on tort damages was harmless, since the jury had only awarded compensatory damages.⁶⁹ While noting the theoretical differences between tort damages and contract damages, the court concluded that "[t]he result is the same, for all practical purposes, as though the jury decided the issue simply on a breach of contract basis."⁷⁰

The court's treatment of the issue in *Theil* leaves much unsettled. By implying that the trial court's instruction on tort damages was an error, even though harmless, the court's decision suggests that an instruction on the implied covenant was not proper in the ordinary commercial contract. The holding therefore seems to contradict the result of *Nicholson*, where the court approved of tort damages in an ordinary commercial contract.

The court similarly failed to state whether adhesion or inequality are prerequisites to the imposition of the implied covenant in a commercial contract in *McGregor v. Mommer*.⁷¹ In *McGregor*, parties of roughly equal bargaining positions negotiated the sale of a gasoline distributorship. Evidence indicated that the sellers had misrepresented the distributorship's profits, had represented that the distributorship's sales to a local station would ensure profits when they knew the station would be closing, and had encouraged the buyer to operate the business as a consignee rather than a jobber when they knew that the oil company would only accept job-

63. *Id.* at ___, 711 P.2d at 830, 832.

64. *Id.* at ___, 711 P.2d at 831.

65. *Id.* at ___, 711 P.2d at 832-33.

66. *Id.* at ___, 711 P.2d at 831.

67. *Id.* at ___, 711 P.2d at 832.

68. *Id.* at ___, 711 P.2d at 833.

69. *Id.*

70. *Id.*

71. ___ Mont. ___, 714 P.2d 536 (1986).

bers.⁷² The trial court instructed the jury on tort damages for breach of the implied covenant.⁷³ The jury awarded \$78,323 in actual damages, \$5,000 for mental anguish, and the trial judge awarded attorney fees of \$20,000.⁷⁴

On appeal, the sellers contended that the instruction on the implied covenant was inappropriate because there was no adhesion or inequality in the bargaining relationship.⁷⁵ The court did not address the appellant's contention but reversed on the ground that the trial court had improperly worded its instruction on the implied covenant.⁷⁶ The court's silence, together with its concern for accuracy in the framing of the bad faith instruction suggests that consistent with its holding in *Nicholson*, it approved of the imposition of the implied covenant in the ordinary commercial contract.

In July of 1986, the court followed its decisions in *Nicholson*, *Theil* and *McGregor* with another major decision which implied the covenant in a commercial contract again without regard to elements of adhesion or inequality of bargaining position. In *Dunfee v. Baskin-Robbins, Inc.*,⁷⁷ the operators of a Baskin-Robbins franchise sought to relocate their store to a more profitable location. The franchise agreement made the decision to relocate a prerogative of Baskin-Robbins' vice-president. Some evidence indicated that a vindictive employee of Baskin-Robbins intentionally failed to inform the vice-president that the Dunfees wished to relocate.⁷⁸ Further evidence showed that an employee of Baskin-Robbins told the Dunfees that they could not relocate because the present lease was for a term of fifteen years.⁷⁹ In truth, Baskin-Robbins could terminate the lease after five years, and could sublease the premises at any time.⁸⁰ After losing their business, the Dunfees brought suit alleging a breach of a fiduciary duty, fraud and breach of the implied covenant. The jury awarded the plaintiffs \$232,138.88 compensatory damages and \$300,000 in punitive damages.⁸¹

On appeal, the court considered whether the trial court erred in its instruction that the franchise agreement contained an im-

72. *Id.* at ____, 714 P.2d at 538-39.

73. *Id.* at ____, 714 P.2d at 542.

74. *Id.* at ____, 714 P.2d at 540.

75. *Id.* at ____, 714 P.2d at 542.

76. *Id.* at ____, 714 P.2d at 543.

77. ____, Mont ____, 720 P.2d 1148 (1986).

78. *Id.* at ____, 720 P.2d at 1155.

79. *Id.* at ____, 720 P.2d at 1150.

80. *Id.*

81. *Id.* at ____, 720 P.2d at 1149.

plied covenant of good faith and fair dealing. The franchise agreement may have qualified for an implied covenant prior to the *Nicholson* decision. The parties may have been of unequal bargaining positions, and the franchise contract may have had many aspects of adhesion.⁸² If such characteristics were present, however, the court did not rely upon them. Instead, the court affirmed the instruction, noting that, in *Nicholson*, it had implied the covenant "in a commercial setting."⁸³ The court's affirmance of the instruction without considering the character of the franchise agreement suggests it held that the implied covenant abides in a commercial contract regardless of whether adhesion or inequality of bargaining positions are present.

IV. THE IMPACT OF NICHOLSON ON PUBLIC POLICY

In many ways the extension of tort liability to an ordinary commercial contract is as significant a change in the common law as the adoption of strict liability for defective products was in the 1970's. Although in the early development of the theory of strict liability "the movement ran considerably ahead of any legal justification for it,"⁸⁴ the courts which first applied a strict liability doctrine for injuries resulting from defective products undertook exhaustive analysis of the social need for such a doctrine.⁸⁵ When the Montana Supreme Court eventually adopted the strict liability doctrine, it carefully listed the policy justifications for adopting the rule.⁸⁶

The court's extension of tort liability to ordinary commercial contracts has significant effects on the theory of contract damages and the costs of doing business. This extension of tort theory has occurred without an analysis of the need for imposing tort damages in the commercial context or its social impact. The court should provide a clear and detailed discussion of the policy reasons supporting its decisions. The following sections discuss the policy reasons for and against the court's action.

82. See *id.* at ___, 720 P.2d at 1156-57 (Weber, J., dissenting).

83. *Id.* at ___, 720 P.2d at 1153.

84. W. KEETON, D. DOBBS, R. KEETON, & D. OWEN, PROSSER AND KEETON ON TORTS § 97 (5th ed. 1984) [hereinafter PROSSER & KEETON].

85. See, e.g., *Greenman v. Yuba Power Prod., Inc.*, 59 Cal. 2d 57, 377 P.2d 897, 27 Cal. Rptr. 697 (1962); *Escola v. Coca Cola Bottling Co.*, 24 Cal. 2d 453, 150 P.2d 436 (1944).

86. *Brandenburger v. Toyota Motor Sales, U.S.A., Inc.*, 162 Mont. 506, 512-15, 513 P.2d 268, 272-73 (1973).

A. Policy Supporting Tort Liability in Ordinary Commercial Contracts

Since no court other than the Montana Supreme Court has fully approved the award of tort damages for breach of the implied covenant in ordinary commercial contracts, the body of thought which supports imposition of tort remedies is understandably small. Nevertheless, a few commentators have advanced arguments which support the court's action. Generally, the commentators justify the use of tort damages by pointing to the inability of contract remedies to accomplish two desired objectives: First, contract damages do not adequately punish or deter wrongful conduct; Second, contract damages do not truly compensate a nonbreaching party or promote the efficient allocation of society's resources. The commentators argue that the failure of contract remedies to promote these desired ends occurs in every type of contract, not just those that courts may classify as "special."⁸⁷ Thus tort damages for breach of the implied covenant should be available in every kind of contract to supplement contract remedies and better promote the desired social objectives.

1. *The Ethical Justification: Deterring Wrongful Conduct*

Unreasonable and unethical conduct can easily taint contractual relationships. In most instances, the resulting injury is not great, and the courts properly overlook such minor incidents as commonplace. Yet there are those incidents which offend intuitive standards of justice and lead the public to seek protection against such conduct in the future. For example, when a supervisor's jealousy over an employee's superior vacation rights results in an otherwise unjustified termination of a twenty-eight year employment contract,⁸⁸ an intuitive sense of indignation demands some redress.

87. Under either the ethical or compensatory justification for extending tort liability, proponents argue that the "special relationship" prerequisite is not justified. The argument, discussed *infra* notes 87-97 and accompanying text, that tort remedies should be used to deter improper conduct suggests that the existence a "special relationship" is irrelevant to determining whether tort liability should be imposed when a party violates a society's ethical norms. Comment, *Tort Remedies*, *supra* note 35, at 392; Diamond, *The Tort of Bad Faith Breach of Contract: When, If at All, Should It Be Extended Beyond Insurance Contracts*, 64 MARQ. L. REV. 425, 430-32 (1981). The compensatory rationale for extending tort liability, discussed *infra* notes 99-111 and accompanying text, argues that the courts should ensure that any inefficient breach results in supplemental compensation, and thus there is no justification for limiting the reforming of contract damages to those relationships deemed "special." *Id.* at 447.

88. Flanigan v. Prudential Fed. Sav. & Loan Ass'n, ___ Mont. ___, 720 P.2d 257 (1986).

If a family franchise goes bankrupt because a vindictive agent of the franchisor failed to communicate a plea to the franchisor's management⁸⁹ it is difficult for courts to resist seeking punishing the wrongful conduct. When an attorney's avarice leads him to drastically increase his fee after the conclusion of a successful dissolution settlement,⁹⁰ one seeks ways to deter such conduct.

Contract law has few means for deterring wrongful conduct. Initially, the wrongful conduct may not accompany a breach of express terms of the contract; until such a breach occurs, traditional contract law is powerless to exact damages from the wrongdoer. The second example described above is one such situation where no breach of the contract occurred, yet the party's conduct in enforcing its contractual rights was unacceptable.⁹¹

Moreover, even if the wrongful conduct accompanies a breach of the contract, the traditional law of contract remedies does not consider such conduct when determining damages. If in one contract a party inadvertently fails to perform his obligation, and in an identical contract a party intentionally breaches the contract out of malice toward the nonbreaching party, a court would award the same damages to each of the nonbreaching parties. The court would make no distinction based upon the culpability of the breaching party's conduct. As Professor Farnsworth explained,

[C]ourts in this country, as in most of the rest of the world, expressly reject the notion that remedies for breach of contract have punishment as a goal, and with rare exceptions, refuse to grant 'punitive damages' for breach of contract. In so refusing they confidently claim to be blind to fault, and they purport not to distinguish between aggravated and innocent breach. So Justice Holmes said, "If a contract is broken the measure of damages generally is the same, whatever the cause of the breach."⁹²

89. *Dunfee v. Baskin-Robbins, Inc.*, ___ Mont. ___, 720 P.2d 1148 (1986).

90. *Morse v. Espeland*, ___ Mont. ___, 696 P.2d 428 (1985).

91. See *supra* notes 77-83 and accompanying text.

92. Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1146 (1970). Justice Holmes also noted,

Nowhere is the confusion between legal and moral ideas more manifest than in the law of contract. . . . The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else. If you commit a tort, you are liable to pay a compensatory sum. If you commit a contract, [sic] you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference. But such a mode of looking at the matter stinks in the nostrils of those who think it advantageous to get as much ethics into the law as they can.

Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) cited in Comment, *Bad Faith Revisited: An Examination of Tort Law Remedies for Commercial Contract Disputes*, 34 KAN. L. REV. 315, 323 n.69 (1985).

To punish and deter noncriminal and yet wrongful conduct, courts generally turn to tort law and the imposition of punitive damages.⁹³ Few courts have disclosed their basis for imposing tort damages for breach of the implied covenant; it appears, however, that the desire to punish unacceptable conduct was a motivating factor. For example, in explaining its prior decision to allow tort damages for breach of the implied covenant in insurance contracts, the California Supreme Court stated, in *Egan v. Mutual of Omaha Insurance Co.*,⁹⁴ that "[t]he obligation of good faith and fair dealing encompass qualities of decency and humanity inherent in the responsibilities of a fiduciary."⁹⁵

In a similar way, courts may justify the extension of tort damages for breach of the implied covenant in ordinary commercial contracts based upon a desire to deter wrongful conduct. The Montana Supreme Court has not expressly stated that its extension of tort remedies was motivated by a desire to deter wrongful conduct, but language from California courts indicates that deterrence of wrongful conduct was a factor supporting the extension of tort damages to ordinary commercial contracts. For example, the sole justification which the *Seaman's* decision offers for allowing tort remedies for a bad faith denial of a contract's existence is that the use of stonewalling tactics "offends accepted notions of business ethics."⁹⁶ In *Quigley*,⁹⁷ the court's analysis of the policy justifications for and against imposing tort damages for breach of the implied covenant in ordinary commercial contracts included the statement that "threat of retribution may discourage unethical business practices."⁹⁸

See also Burnham, *Contract Damages in Montana Part I: Expectancy Damages*, 44 MONT. L. REV. 1, 45 (1983) ("The rule [prohibiting punitive damages for breach of contractual obligations] is applied irrespective of the motive of the breacher or the willfulness or fraudulence of his or her actions.").

93. PROSSER AND KEETON, *supra* note 84, § 4, at 21-23.

94. 24 Cal. 3d 809, 620 P.2d 141, 169 Cal. Rptr. 691 (1979).

95. *Id.* at 821, 620 P.2d at 146, 169 Cal. Rptr. at 696 (quoting Goodman & Seaton, *Forward: Ripe for Decision, Internal Workings and Current Concerns of the California Supreme Court*, 62 CAL. L. REV. 309, 346-47 (1974)). The courts have not, however, consistently viewed the obligation created by the implied covenant as requiring compliance to community standards of moral conduct. See *Neal v. Farmers Ins. Exch.*, 21 Cal. 3d 910, 922 n.5, 582 P.2d 980, 986 n.5, 148 Cal. Rptr. 389, 395 n.5 (1978), which notes that the drafters of the Restatement of Contracts (Second) exclude from the definition of good faith and fair dealing consideration of conduct that might, in other contexts, be deemed "bad faith" "because they violate community standards of decency, fairness or reasonableness."

96. *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 769, 686 P.2d 1158, 1167, 206 Cal. Rptr. 354, 363 (1984).

97. *Quigley v. Pet, Inc.*, 162 Cal. App. 3d 877, 208 Cal. Rptr. 394 (1984).

98. *Id.* at 891, 208 Cal. Rptr. at 402. Montana's extension of tort remedies for breach of the implied covenant, however, can be attributed to the ethical justification. In statutory

2. *The Compensatory Justification: Supplementing Expectancy Damages Upon Breach of Contract*

A widely publicized justification for the imposition of tort remedies for breach of the implied covenant in ordinary commercial contracts has been that such damages are necessary to promote the basic objectives of contract law. While in theory the law of contract damages places the nonbreaching party in the same position which he or she would have been in had the contract been performed, i.e., fulfills the nonbreaching party's expectancy, the practical application of the theory fails to accomplish this end. The result of undercompensation is that parties are not deterred from breaching contracts in a manner that inefficiently allocates society's resources. To correct the problem of undercompensation, commentators urge courts to impose tort damages upon breach of contracts in certain instances.⁹⁹

and decisional law, the imposition of tort damages, and especially punitive damages, is strongly linked to the culpability of the breaching party's conduct. For example, MONT. CODE ANN. § 28-1-221 (1985) limits an award of punitive damages to cases where there has been a high degree of unethical conduct. When the court first approved the award of punitive damages for breach of the implied covenant in an insurance contract, it did so on the basis that the defendant's conduct was potentially subject to criminal sanctions under the Insurance Code. *Larson v. District Ct.*, 149 Mont. 131, 423 P.2d 598 (1967); *First Sec. Bank of Bozeman v. Goddard*, 181 Mont. 407, 593 P.2d 1040 (1979). Since the criminal sanctions plainly indicated that the conduct was deemed socially undesirable, punitive damages were used to deter such conduct.

Other evidence of the court's adherence to the ethical justification for imposing tort remedies for breach of the implied covenant lies in the court's concentration on the party's conduct even in the absence of a breach of the express terms of the contract. The court has imposed tort damages for conduct that did not breach any express contractual provision. In *Dunfee v. Baskin-Robbins, Inc.*, ___ Mont. ___, 720 P.2d 1148 (1986), the court affirmed an award of tort damages when there had been no breach of an underlying contract. The Dunfee's franchise agreement with Baskin-Robbins allowed Baskin-Robbins to refuse the Dunfees' request to relocate their store. Baskin-Robbins' tortious conduct was in exercising this contractual right in an unreasonable manner. The court stated that "in the case at bar, the jury had to focus upon the appellant's conduct in performing the contract rather than breaching the contract." *Id.* at ___, 720 P.2d at 1153. The *Dunfee* decision cannot be based upon the compensatory justification for imposing tort damages since that justification is based upon the premise that, upon breach of some contractual provision, normal contract damages are insufficient.

The Montana court's effort to inject moral standards in the contract arena appears to reflect deep-seated Montana sentiments. Proponents of the implied covenant before the 1987 legislature stressed that the implied covenant embodies basic Montana business ethics, where "a man's handshake is his word." Thus there is reason to conclude that the ethical justification for extending the implied covenant and its tort remedies into ordinary commercial contracts which is the justification most compatible with the court's vision for the implied covenant.

99. Diamond, *supra* note 87, at 448. Diamond's thesis is that tort remedies are appropriate when the breaching party could not have reasonably believed that his or her gains would exceed the promisee's compensable pecuniary losses. See also Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443,

As most commentators explain it, contract theory seeks to promote economic growth by allowing, and in fact encouraging, parties to breach those contracts in which the cost of performing the contract exceed the nonbreaching party's losses upon nonperformance.¹⁰⁰ Stated more fully, contract law encourages a party to breach a contract when his or her costs of performance, either in actual costs or the loss of foregone profits, exceeds the cost of placing the non-breaching party in the same position he or she would have been if performance had occurred. Commentators refer to these breaches in which the breaching party's gains exceeds the nonbreaching party's losses as "efficient" breaches.¹⁰¹

In addition to allowing and encouraging parties to make efficient breaches, contract damages in theory also deter breaches which are "inefficient." An inefficient breach is a breach in which the losses to the nonbreaching party exceed the benefits the breaching party gains as a result of the breach.¹⁰² Since, in theory, the law of contract damages will ensure that the breaching party will ultimately compensate the nonbreaching party for its losses, the breaching party is discouraged from breaching when the cost of the breach outweighs its benefits.¹⁰³ The scheme of encouraging and discouraging certain kinds of breaches theoretically promotes the efficient allocation of society's resources.¹⁰⁴ Encouraging efficient breaches tends to ensure that the breaching party will not spend more resources in performance of the contract than the non-

1476-77 (1980).

100. Diamond, *supra* note 87, at 437-438; R. POSNER, *ECONOMIC ANALYSIS OF LAW* 89-90 (2d ed. 1977).

101. Professor Diamond provides an example of an "efficient" breach:

[A]ssume that Seller, a manufacturer of widgets, has contracted to supply Buyer with all widgets Buyer may require for a specified period at a unit price of \$1.00. Subsequent to formation of the contract, Seller has the opportunity to reallocate its resources, cease production of widgets and commence manufacturing widgets, which have a market value of \$2.00, without increasing production costs. If the market price for widgets is \$1.30 per unit, resulting in damages to Buyer of at least \$.30 per unit, Seller will be economically induced to breach its contract and reallocate its resources since the gains from breach, \$1.00 per unit, will significantly exceed Buyer's legal damages.

Diamond, *supra* note 87, at 435-36.

102. Professor Diamond again provides an example of an inefficient breach:

If our manufacturer of widgets sought to avail itself of the increased market price for widgets by selling the contracted for goods to an alternative purchaser, its gain per widget would be at least equalled by [B]uyer's losses in having to pay the increased market price from an alternative seller. There is, therefore, no socio-economic justification for breach.

Id. at 438.

103. *Id.*

104. *Id.* at 437; Posner, *supra* note 100, at 89-90.

breaching party, and eventually society, will receive from its performance. Discouraging inefficient breaches promotes society's interest in seeing that the breaching party's benefits as a result of breach are not achieved at a higher cost to the nonbreaching party.

Commentators are quick to point out the error in the application of the theory: traditional contract damages do not truly fulfill the nonbreaching party's expectancy.¹⁰⁵ The nonbreaching party must bring suit to enforce his or her rights. This involves substantial costs and attorney fees, which are usually not included in the party's expectancy damages. Such costs often make full prosecution unprofitable, and the party either fails to bring suit or settles for substantially less than actual damages.¹⁰⁶ The cost of bringing suit thus discourages the non-breaching party from fully enforcing his or her rights against the breaching party.¹⁰⁷ Because they don't expect to pay damages to the nonbreaching party, promisors often breach even when it is inefficient to do so. Consequently, undercompensation subverts the purpose of contract law of deterring inefficient breaches. As Professor Diamond states:

The remedial scheme of contract law was premised on the promisor's recognition of the economic consequences of actually having to pay an injured promisee's damages. The reality is the promisor's recognition of the economic consequence of not actually having to pay the promisee's damages. As long as this reality exists, the justice of the law of contract remedies is a fiction.¹⁰⁸

Many commentators see the expansion of tort principles into the arena of contract law as a reaction to undercompensation.¹⁰⁹ The failure of contract law to fully compensate the non-breaching party encourages courts to award damages other than or in addition to ordinary expectancy damages.¹¹⁰ Some commentators have encouraged the use of tort remedies to compensate non-breaching parties; with their more lenient requirements for proving damages, the rules for imposing tort damages provide the extra compensation needed to protect contractual principles.¹¹¹

105. See Burnham, *supra* note 92, at 2-3; Diamond, *supra* note 92, at 440-443; Farber, *supra* note 99, at 1476; Comment, *Tort Remedies*, *supra* note 35, at 399; Comment, *Sailing the Uncharted Seas*, *supra* note 35, at 1189.

106. Farber, *supra* note 92, at 1444-45.

107. See *supra*, note 10.

108. Diamond, *supra* note 87, at 442-43.

109. *Id.* at 445; Speidel, *supra* note 9, at 195; Comment, *Sailing the Uncharted Seas*, *supra* note 35, at 1189.

110. Burnham, *supra* note 92, at 3.

111. See note 99.

B. *Reasoning Opposing Tort Damages in Commercial Contracts*

Reasoning which rejects the application of tort remedies for breach of the implied covenant in ordinary commercial contracts begins with an acknowledgement of the ethical and compensatory inadequacies of traditional contract damages theory.¹¹² The central reason to reject tort damages as a means to correct these inadequacies is that the extension of tort damages in ordinary commercial contracts is costly. Commentators, and the California courts which have considered the issue have weighed the costs of an extension of tort damages for breach of the implied covenant to ordinary commercial contracts.¹¹³ The harmful effects cited include: 1) an invasion upon the parties' freedom of contract, 2) a chilling effect on the parties' freedom to make an efficient breach and their willingness to enter into contracts in the first place, and 3) a mixture of contract law with tort law.

a. *Interfering With Freedom of Contract*

Critics fear that the transformation of promissory liability inherent in contract law to tort liability removes a significant amount of freedom which the parties to a contract normally have to shape the parameters of their agreement.¹¹⁴ Normally parties to a contract may agree what their responsibilities to one another shall be.¹¹⁵ While even the implication of a covenant as a contractual term interferes with the parties' freedom of contract, it is generally recognized that the parties are free to agree upon reasonable standards by which they will measure one another's conduct.¹¹⁶ The imposition of tort duties interferes with the parties' right to freely contract concerning the scope of their responsibilities since a social standard now measures the parties' performance.

The need to preserve freedom of contract suggests that tort damages should be available only when the bargaining relationship

112. A more basic question, not examined here, is whether the state should be concerned with deterring wrongful conduct and correcting undercompensation in ordinary commercial contracts. This comment proceeds under the assumption that public policy requires that the court or the legislature should correct the inadequacies of traditional contract damage theory.

113. For an analysis of the California court's reasoning see *supra* notes 26-38 and accompanying text.

114. See Louderback & Jurika, *Standards for Limiting the Tort of Bad Faith Breach of Contract*, 16 U.S.F.L. Rev. 187, 220 (1982).

115. See *id.* at 220-21.

116. *Seaman's Direct Buying Serv. v. Standard Oil of Cal.*, 36 Cal. 3d 752, 769, 686 P.2d 1158, 1167, 206 Cal. Rptr. 354, 363 (1984).

contains aspects of adhesion and inequality of bargaining positions.¹¹⁷ There is no need to to preserve the parties' freedom to negotiate when, due to adhesion or inequality of bargaining position, one party to the contract is dictating the terms anyway.¹¹⁸

The Montana Supreme Court's current definition of bad faith conduct defines bad faith conduct as conduct which exceeds one party's reasonable expectation that the other party will act as a reasonable person.¹¹⁹ This definition, which apparently focuses on the parties' expectations rather than on an extra-contractual obligation, would seem to allow the parties' intent to enter into a determination of whether bad faith conduct has occurred. One question remains unanswered: would the court enforce a contractual provision setting reasonable standards for defining bad faith conduct? If the court were to allow parties to contractually define their "tort" obligations in this manner, the implied covenant would no more impinge upon the parties' freedom of contract than traditional contractual obligations of good faith and fair dealing.¹²⁰

b. *The Effect of Tort Damages upon Commercial Transactions*

In addition to interfering with the parties' freedom to contract, tort damages may hinder efficient allocation of resources. Tort damages, and particularly punitive damages, in an ordinary commercial contract may deter future misconduct, but do so at a high social cost. As noted earlier,¹²¹ punishment of unethical conduct in breaching a contract is not a purpose of contract law. The law's neutrality to a party's conduct in breaching a contract has supported efficient allocation of resources through concentrating on the loss caused by the breach rather than the breaching party's motive.¹²² If tort damages are imposed upon breach, parties fearing greater damages than merely the non-breaching party's expectancy damages will be discouraged from breaching the contract even when it is no longer efficient to perform the contract.¹²³ Additionally, the threat of excessive damages upon breach of contract may

117. See Louderback & Jurika, *supra* note 114, at 221-23.

118. *Id.*

119. *Nicholson v. United Pacific Ins. Co.*, ____ Mont. ____, ____, 710 P.2d 1347, 1348 (1985).

120. Allowing parties to set standards by which their tort obligations may be judged would further enlarge the mixture of Tort law with Contract law. See *infra* notes 133-39 and accompanying text.

121. *Supra* notes 91-92 and accompanying text.

122. Diamond, *supra* note 87, at 437.

123. Diamond, *supra* note 87, at 439.

discourage parties from entering into contracts in the first place.¹²⁴ Punishment of wrongdoing, without a concern for the efficiency of the breach, therefore undermines the foundations of contract law.¹²⁵

In *Nicholson*, the court recognized the need to allow parties to freely breach a contract. It upheld the right to make an intentional, self-interested breach without incurring tort liability.¹²⁶ The promisor breaches the implied covenant, however, and is thus subject to tort liability when his or her conduct exceeds the other party's justifiable expectation that the promisor will act as a reasonable person.¹²⁷ The court thus informs promisors that they may freely breach their contracts in any circumstances,¹²⁸ but will be subject to tort damages if their conduct is so arbitrary, capricious or unreasonable that it exceeds another party's justifiable expectations.¹²⁹

The effect of the *Nicholson* decision is to raise at least the threat of punishment for wrongful conduct upon every breach of contract. Courts and commentators have expressed concern that the extension of tort remedies in ordinary commercial contracts will result in a tort claim accompanying every claim for breach of contract.¹³⁰ The businessperson contemplating a breach of contract must therefore question whether his or her actions will breach the tort duty. Yet there is little clarity in the court's standards for what conduct constitutes a breach of the implied covenant.¹³¹ Uncertainty may force the party to avoid breach even though it is economically efficient to do so. The threat of additional, unbar-gained-for damages also may discourage parties from entering contracts.¹³²

124. *Id.*

125. *Id.*

126. *Nicholson*, ____ Mont. ____, 710 P.2d at 1348.

127. *Id.*

128. The court did not adopt the remainder of Diamond's analysis which argues that tort liability should be imposed when the party willfully breaches when he or she could not have reasonably believed that his or her gains would exceed the promisee's compensable pecuniary losses. Diamond, *supra* note 87, at 448.

129. The court's holding is another indication that the court is more concerned with deterring unethical conduct than ensuring full compensation to the non-breaching party.

130. See *Battista v. Lebanon Trotting Ass'n*, 538 F.2d 111 (6th Cir. 1976); see also *Seaman's Direct Buying Serv.*, 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354.

131. See *Survey, Good Faith and Fair Dealing: An Analysis of Recent Cases*, 48 MONT. L. REV. 193 (1987). See also *Burton*, *supra* note 5.

132. There is a strong argument that uncertainty in the standards for imposing tort, and especially punitive, damages also results in unfair and inefficient punishment. An analysis of uncertainty in imposition of punitive damages by D. Ellis, Jr., *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. CAL. L. REV. 1 (1982), concluded that uncertain

c. *The Distortion of Contract Law*

In addition to the real social costs which punitive damages in an ordinary commercial context would create, the application of tort damages for breach of the implied covenant distorts the borderline between Contract and Tort. In fear of a mixture of Contract law with the law of Torts, the First Restatement of Contracts stated that punitive damages were not proper even if the party's actions both breached the contract and a constituted tort.¹³³ The Second Restatement of Contracts, however, now allows for tort damages if the conduct constituting the breach of contract is also a tort.¹³⁴

The Montana court¹³⁵ and the courts of other jurisdictions¹³⁶ have allowed the award of punitive damages for breach of the implied covenant on the grounds that the duty to act in good faith and fair dealing arises outside the contract. There is reason to believe that this characterization is a fiction. Despite the court's claims to the contrary, the duty created by the implied covenant can not be separated from its contractual heritage. In its recent description of the nature and scope of the implied covenant, the Montana court described a contractual duty, not a tort duty:

The nature and extent of an implied covenant of good faith and fair dealing is measured in a particular contract by the justifiable expectations of the parties. Where one party acts arbitrarily, capriciously or unreasonably, that conduct exceeds the justifiable expectations of the second party. The second party then should be compensated for damages resulting from the other's culpable conduct.¹³⁷

standards for determining liability reduce the effectiveness of tort damages in deterring wrongful conduct and increase the threat of the unfair punishment of an innocent party. The policy of other jurisdictions, which impose punitive damages only when all other remedies are either unavailable or ineffective therefore appears to be justified. *See, e.g.,* *Grimshaw v. Ford Motor Co.*, 119 Cal. App. 3d 757, 174 Cal. Rptr. 348, (1981), in which the court reasoned:

It is precisely because monetary penalties under government regulations prescribing business standards or the criminal law are so inadequate and ineffective as deterrents against a manufacturer and distributor of mass produced defective products that punitive damages must be of sufficient amount to discourage such practices.

Id. at 820, 174 Cal. Rptr. at 389.

133. RESTATEMENT (FIRST) OF CONTRACTS § 342, comment c (1933).

134. RESTATEMENT (SECOND) OF CONTRACTS § 355, comment b (1981).

135. *See supra*, notes 17-18 and accompanying text.

136. *See, e.g.,* *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 574, 510 P.2d 1032, 1037, 108 Cal. Rptr. 480, 485, (1973).

137. *Nicholson*, *Mont.* at _____, 710 P.2d at 1348.

Tort duties are based upon what expectations the community places upon an individual's actions.¹³⁸ The duty described by the court is based upon the expectations of the contracting parties, and thus looks more like a duty arising out of the contract.¹³⁹

V. AVOIDING TORT DAMAGES IN ORDINARY COMMERCIAL CONTRACTS: ALTERNATIVE MEANS OF ACHIEVING DETERRENCE AND FULL COMPENSATION

The 1987 Montana Legislature recently considered legislation that abolished the common law tort cause of action for breach of the implied covenant. The legislature's concern indicates that legislators perceived problems with the court system's application of the implied covenant. The legislative reforms proposed would have corrected the harmful effects of imposing tort liability in ordinary commercial contracts. The reforms, however, did not consider using alternative mechanisms to achieve the public policy objectives of deterrence of wrongful conduct and full compensation.

A. Regulatory Solutions

Tort law is not the exclusive arena for deterring unethical conduct. Criminal and regulative penalties also provide deterrence. Statutory law commonly regulates the contracting relationship, as is evidenced in consumer protection legislation. If the legislature deems certain conduct which may occur in ordinary commercial contracts to be unacceptable, it could provide statutory penalties for such conduct.¹⁴⁰

138. "Tort obligations are in general obligations that are imposed by law — apart from and independent of promises made and therefore apart from the manifested intention of the parties —to avoid injury to others." PROSSER AND KEETON, *supra* note 84, § 92 at 655. See also *Iron Mountain Sec. Storage v. American Specialty Foods, Inc.*, 457 F. Supp. 1158, 1165 (E.D. Pa. 1978).

139. See PROSSER & KEETON, *supra* note 84, at 656.

140. In the insurance area, for example, the Unfair Trade Practices Act of the Insurance Code, MONT. CODE ANN. § 33-18-101 *et seq.* (1985) penalizes certain forms of unethical conduct with fines and criminal penalties. See MONT. CODE ANN. § 33-18-201 (1985) The Montana Supreme Court originally based the duty to act in good faith in the insurance relationship on the existence of the Act. *Larson*, 149 Mont at 135-36, 423 P.2d at 600; *Godard*, 181 Mont. at 420, 593 P.2d at 1047. The Act proved deficient, however, in that it did not deter all the improper conduct possible in the insurance area. In *Lipinski v. Title Ins. Co.*, 202 Mont 1, 15, 655 P.2d 970, 977 (1982), the court abandoned the Code as a definition of the duty to act in good faith because the improper conduct of the defendant's failure to defend was not one of the proscribed activities of the Act. The Act further proves inadequate to protect insureds in that it requires the injured party to prove that the insurer regularly engaged in the proscribed conduct so as to constitute a "general business practice." Although the court has significantly liberalized this requirement, (see *Fode v. Farmers Ins. Exch.*, ___ Mont. ___, 719 P.2d 414 (1986)) the Act still proves inadequate to provide

B. *The Reform of the Law of Contract Damages*

In House Bill 592 as proposed to the Senate Judiciary Committee, the Montana Liability Coalition attempted to limit damages for breach of the implied covenant to a measure of contract damages only. If passed, the amendments would have made Montana's law regarding breach of the implied covenant in ordinary commercial contracts conform with the rule in California.¹⁴¹ As has been shown, however, contract damages are limited in their ability to deter improper conduct and to compensate a non-breaching party. To properly cure these limitations, the legislature should revise the damage rules themselves.¹⁴²

The measure of damages for breach of a contractual obligation is generally limited to compensating those losses which naturally arise from a breach and those losses that are specially made foreseeable at the time the parties entered into the contract.¹⁴³ While the foreseeability requirement helps to ensure that parties correctly calculate the costs of their bargain before they enter into it and thus helps to efficiently allocate society's resources,¹⁴⁴ there is authority for relaxing the foreseeability requirement in cases of bad faith conduct.¹⁴⁵ By relaxing the foreseeability requirement, the court or the legislature could ensure full compensation to the aggrieved party by including transaction costs, lost profits, and costs of suit.¹⁴⁶

The law of contract damages also requires certainty as to the origin and nature of the plaintiff's losses.¹⁴⁷ The courts must still require a showing that the defendant's bad faith conduct caused a loss to the plaintiff, but courts should continue to allow the plain-

sufficient protection to the insured.

The 1987 Legislature, in HB 240, returned the law of insurance bad faith to being a statutory cause of action. It is unclear how the Montana Supreme Court's recent decision to declare constitutional initiative 30 invalid will affect this and other "tort reform" legislation. Should the legislation survive attack it would prove deficient in its definition of wrongful conduct; for example, the Act would not provide a cause of action for a failure of the insurer to defend its insured, as in *Lipinski*. The predicament illustrates the trade-offs inherent in choosing the certainty provided by a statutory definition of wrongful conduct over the flexibility provided by a common law tort cause of action.

141. See *supra* notes 26-38 and accompanying text.

142. Schwartz, *Deterrence and Punishment in the Common Law of Punitive Damages*, 56 S. CAL. L. REV. 133, 139-40.

143. MONT. CODE ANN. § 27-1-311 (1985); see Burnham *supra* note 92, at 4-11.

144. Farnsworth, *supra* note 92, at 1208.

145. See *id.* at 1209 & n.274 (quoting McCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 141, at 581 (1935): "Our rules should sanction, as our actual practice probably does, the award of consequential damages against one who deliberately and wantonly breaks faith, regardless of the foreseeability of the loss when the contract was made.")

146. Comment, *Tort Remedies*, *supra* note 35, at 403.

147. MONT. CODE ANN. § 27-1-311 (1985); Burnham, *supra* note 92, at 11-13.

tiff to show the amount of loss with only a reasonable certainty.¹⁴⁸

The legislature can ensure a non-breaching party receives his or her actual expectancy by making specific statutory reforms aimed at defraying the costs of bringing suit. Currently, a plaintiff seeking to enforce a right to contract damages must pay his or her own attorney fees and most costs.¹⁴⁹ As noted earlier, the plaintiff that incurs legal fees and costs in enforcing a contractual right will in actuality recover less than the benefit of the bargain which was lost upon the breach.¹⁵⁰ The legislature should allow plaintiff to recovery attorney fees and full costs as consequential damages when he or she can show that the defendant acted in bad faith.¹⁵¹

The courts and legislature should also allow parties of equal bargaining position to liquidate damages, or at least damages arising out of a breach of the implied covenant. Liquidated damages are permissible in Montana as long as there is some relation to what normally would be due the aggrieved party through contract damages.¹⁵² The statute and decisional law express a fear that liquidated damages will punish the breaching party instead of compensating the aggrieved party. Commentators that propose a relaxation of the limits on liquidated damages argue that parties to an arm's length contract would not include liquidated damages if they had no relation to a party's expectancy interest.¹⁵³ Under a policy of promoting full compensation of a non-breaching party's expectancy interest, liquidated damages ensure a fuller compensation of a party's expectancy interest because there are fewer costs of litigation involved.¹⁵⁴ Even if liquidated damage clauses were punitive in their nature, allowing the parties to contract for their liability provides more predictability than requiring the parties to take their chances on what a jury may award upon breach of the implied covenant.¹⁵⁵

148. See Burnham, *supra* note 92, at 12-13.

149. See Burnham *supra* note 92, at 47 & n.311 (attorney fees are generally borne by each party) and at 47-48 (noting the inadequacies of MONT. CODE ANN. § 25-10-201 (1985), which allows for a limited award of costs).

150. See *supra* notes 105-08 and accompanying text.

151. To be effective, clear standards of what constitutes bad faith conduct would be necessary.

152. MONT. CODE ANN. § 28-2-721(2) (1985); *Morgan & Oswood Contr. Co. v. Big Sky of Mont.*, 171 Mont. 268, 557 P.2d 1017 (1976); Burnham, *supra* note 92, at 41-42.

153. Farber, *supra* note 99, at 1477.

154. Goetz & Scott, *Liquidated Damages, Penalties and Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 559 (1977).

155. See Farber, *supra* note 99, at 1477 (suggesting that courts should allow parties to direct liquidated damage clauses to incidences of bad faith conduct.)

A liberalized rule of contract damages for breach of the implied covenant would, in theory, provide some deterrence of improper conduct. Empirical evidence that broader contract damages would deter wrongful conduct is not available, but it is likely that the threat of larger damages would encourage businesses to minimize their liability by avoiding wrongful conduct. The facts of *Dunfee v. Baskin-Robbins*¹⁵⁶ provide an example. If the court had held that the franchise agreement contained an implied covenant which required Baskin-Robbins to address the Dunfees' relocation request with good faith, Baskin-Robbins would have been assessed contract damages. Liberalized foreseeability requirements would have allowed the Dunfees to recover lost profits which were reasonably certain to have been caused by the franchisor's bad faith.¹⁵⁷ It is reasonable to believe that the threat of contract damages would have encouraged Baskin-Robbins to employ policies that would ensure fair treatment of its franchisees.

Contract remedies for breach of the implied covenant, liberalized and bolstered with the above reforms would also achieve the compensatory ends justifying the extension of tort damages for breach of the implied covenant to ordinary commercial contracts. The increased award to the plaintiff would ensure a fairly exact compensation of the plaintiff's expectancy interest. Thus an award of contract damages would discourage the inefficient breach, without the harmful effects of imposing tort damages.

VI. CONCLUSION

The Montana Supreme Court's decision to extend tort damages for breach of the implied covenant in ordinary commercial contracts was unprecedented among all American jurisdictions. No other jurisdiction has so boldly exploded the principled limits which have restricted the application of tort damages for breach of the implied covenant. Despite its far-reaching impact, the court's decision lacked a discerning exposition of the policy justifying the imposition of tort damages within ordinary commercial relationships.

This Comment concludes that tort damages are inappropriate for breach of the implied covenant in ordinary commercial contracts. Imposing tort remedies in such cases generates substantial

156. ____ Mont. ____, 720 P.2d 1148 (1986).

157. Normally, contract damage theory makes recovery for lost profits difficult. See Burnham, *supra* note 92, at 13-14. Therefore the Dunfees would have recovered very little under traditional contract damage theory, and the cost of bringing suit may have prevented them from bringing an action.

and yet unnecessary harms. To fairly and efficiently deter wrongful conduct, the Montana Supreme Court should revise its anomolous tort theory for breach of the implied covenant in ordinary commercial contracts. The court should adopt the rule of the majority of jurisdictions and imply the covenant, as a contractual term, in every contract. The court should develop principled limits, such as those employed by the California courts, to limit the availability of tort damages for breach of the implied covenant to only contracts of "special relationships."

The Montana Legislature should assist, rather than resist, the court's effort to deter unethical conduct in the performance of contracts and ensure full compensation to a non-breaching party in ordinary commercial contracts. It should explore regulatory mechanisms to reach these ends, and employ statutory reforms of the law of contract damages.

